ARGUS®

WEEKLY ECONOMIC COMMENTARY

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Jobs/GDP Divergence Continues: Our Monthly Survey of the Economy, Interest Rates, and Markets

Despite a nudge higher from the advance report, preliminary 1Q17 GDP grew at an anemic 1.2%. Investors could not even point to harsh weather, which has hindered economic activity in recent first quarters. Winter 2017 was mild in most of the nation.

May nonfarm payrolls missed consensus, coming in below 140K; and March and April were revised lower. Still, the slowing pace of job additions reflects the successful rebuilding of the employment economy. U3 unemployment of 4.3% is at its lowest level in 16 years, testament to a fully employed workforce. The corollary effects of nearly full employment are now being felt in wage gains: hourly wages in May rose at a 2.5% annual rate.

The failure of a vibrant jobs economy to drive higher levels of GDP growth triggers blithe explanations. The most familiar explanations are that GDP can't grow amid stagnant productivity growth; and that aging baby boomers are in a "defensive crouch," meaning they are not spending on the big-ticket items (homes, cars, boats) that formerly drove growth. Boomers are not riding quietly off into the sunset, however; they are working later in life than any prior generation. And boomers in many cases are having a "second childhood" of spending, helping their offspring finance big-ticket items that are out of reach for college-loan-burdened graduates.

We think anemic productivity growth can be attributed to tepid investment by corporations. Yes, the employment situation is the best it has been since the recession. Many of the jobs created are in labor-intensive consumer-driven industries such as housing and automotive services. We believe the key to getting productivity back on track, and with it GDP growth, is recovery in capital spending.

Buried in the weak 1Q17 GDP report was good news on non-residential fixed investment. This metric, regarded as a proxy for corporate capital spending, was up 11.4% in 1Q17 and also featured high-single-digit growth in spending on equipment and spending on intellectual property products.

Simply given the weak start to the year, GDP in 2Q17 will likely rebound. We expect improving fundamentals, particularly in the industrial economy, to drive better GDP growth across the balance of 2017.

THE ECONOMY, INTEREST RATES, AND EARNINGS

For close to a decade, GDP growth has been dragging along at about a 2% rate. This has been true in periods of strong earnings growth. For the 1Q17 calendar quarter, continuing operations earnings rose a healthy 14% year-over-year. GDP has also been weak in recent periods of full employment. In May, the U3 unemployment rate hit a 16-year low of 4.3%.

Persistently weak GDP growth underscores the challenge of driving sustainable 3% GDP growth in a large and complex economy undergoing significant digital disruption and experiencing drags from low productivity growth and aging baby boomers. Preliminary first-quarter 2017 U.S. GDP grew at a 1.2% rate, down from 2.1% growth in 4Q16. The problem in 1Q17 was a tight-fisted consumer, as real personal consumption expenditures (PCE) rose 0.6%. That is down from full-year 2016 average PCE growth of 2.7%. Weak auto unit sales so far this year show no signs of abating. And now housing data suggests a pause may be developing in new and existing home sales. All in all, investors should not count on a sudden rebound in consumer activity.

Things are looking brighter on the industrial & commercial side of the economy. Non-residential fixed investment, seen as a proxy for capital spending, was up 11.4% in 1Q17. Growth in structures was driven by growth of 7.2% in

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spending on equipment and 6.7% in spending on intellectual property products, which drives future productivity. Exports were up 5.8% in 1Q17, while imports increased a lesser 3.8%, meaning trade was net contributive to GDP growth.

We should get at least a modest rebound quarter in 2Q17, potentially exceeding 3%. We continue to model full-year 2017 GDP growth in the 2.0% to 2.5% range. Where we fall in that range will depend on how much bounce-back we get in coming quarters. With oil coming down, imports should remain subdued and potentially grow less than exports. The industrial economy is showing positive signs, but will need to sustain growth. Consumers may continue to avoid auto showrooms, but the housing economy is vital to overall consumer spending patterns.

For 2018, we continue to forecast GDP in the 2%-3% range, with plans to provide further refinement to our estimate as 2017 progresses. Our assumption is that President Trump's fiscal stimulus programs on taxes and infrastructure spending will have a bigger impact next year.

Stocks have moved to record highs. Yet the advance has become thin, with key sectors absent and others not fully committed. Another surprising feature of this unloved stock rally has been a retreat in bond prices. Normally when stocks are hitting new all-time highs, the economy is heating up, inflation is a growing concern, and rates are rising. The Fed seems highly likely to raise short-term rates in June, which would seem to suggest further upwards pressure in rates.

While short-term rates have moved higher in the past month, rates at the long end have actually come down. The three-month bill is now at 0.96%, compared to 0.79% a month ago. Back then, investors were divided on whether the Fed would move in June. Curiously, as consumer data has signaled a pause, investor conviction has increased that the Fed will hike rates.

The divide begins in the middle of the curve, at two-year and five-year Treasuries, where yields are within a few basis points of last month's level. At the long end, rates are down month-over-month. The 10-year yield, at around 2.21%, has slipped down from 2.30% in the past month; the 30-year has also declined.

As a result of these movements at the upper and lower ends of the rate spectrum, the yield curve has once again lost some of its slope. Yield curve flattening is associated with rising risk of recession.

We continue to see limited risk of recession, given strong underlying fundamentals in the economy. These include relatively full employment, with the recent 4.3% unemployment rate hitting 16-year lows; rising wages, which are increasing consumer buying power; and positive signs from the industrial economy and from overseas. Balanced against those positives are concerns about housing and autos, twin drivers of the consumer economy. Our bigger current fear is inflation, although recent economic signals have not been too worrisome.

The first-quarter earnings season is now largely in the books. First-quarter EPS rose a robust 14%, exceeding our forecast, which was among the most aggressive on the Street. The glow won't last, however, if EPS slips back into low-growth mode. Mid-July and the 2Q earnings season are not far off. It is not too soon to take a look at the 2Q17 EPS outlook.

Currently, Argus is forecasting 13% year-over-year EPS growth from continuing operations for 2Q17. The earnings leaders in 2Q17 were mainly among the economically sensitive groups such as industrials, technology, and consumer discretionary. We also saw good growth in "wealth in the ground" sectors such as materials and energy. Despite accounting for over 300 basis points of overall earnings growth in 1Q17, energy is still a suspect sector as far as investors are concerned; and energy continues to lag in the stock market.

We forecast a continuation of the double-digit growth trend for the second half of 2017. EPS growth could moderate slightly in the back quarters of 2017 but should remain well above the preceding three-year trend of flat to slightly up or down earnings.

While the bias in EPS is likely higher, we are reiterating our forecast for full-year 2017 S&P 500 earnings from continuing operations of $134, which would be up 12.6% for the year. For now, we are modeling high-single-digit growth in 2018, with first half 2018 quarterly EPS growth in the 7%-8% range giving way to second-half quarterly EPS growth in the 6%-7% range. Potential roadblocks to EPS growth include the potential for worsening inflation; higher interest rates as the Fed seeks to cap pricing pressures; and a further rise in geopolitical tensions. There are also potential positives that might impact 2017 and more meaningfully 2018 earnings, including possible tax cuts, infrastructure investments, or other stimulative fiscal policy measures.

DOMESTIC AND GLOBAL MARKETS

Domestic stock index performance was generally positive in May, with the simple average of our index aggregate adding 200 basis points month-over-month. The aggregate is up 8.9% year-to-date, compared with 6.9% as of the end of April. But the performance has gotten more varied and to some extent more difficult to predict.

Nasdaq and growth remain the leading themes, with both up in the high-teens year to date. Blue chip is on the next performance tier, with the S&P 500 and DJIA up in the high-single-digit to low-double-digit range. The fall-off to the next tier is considerable, with both value and Russell 2000 in low single digits. Yet these two groups, value stocks and small-cap stocks, could not be more different.

The Lehman Aggregate Bond Index has doubled its year-to-date return, to up 2.6% after May from up 1.3% just after April. That is despite the imminence of the Fed's fourth rate hike in the current cycle, widely expected in June.

Even more than in April, sector performance in May showed increasing dispersion in terms of relative performance. Within the S&P 500, a handful of sectors are up in double-digits. That includes technology, which has already crossed the 20% capital-gain threshold with a 22% year-to-date gain.

Healthcare and consumer discretionary are also up in low double digits as they were in April. They have now been joined by consumer staples and utilities, both also up in low double digits. In the second tier of sectors that are beating or matching the market are materials and industrials. Financials are up in low single digits.

Considering the two sectors that we identified last month as being down in high single digits, one – telecom services – remains in that position, while the other – energy – has seen its annual decline worsen to just under 13%. The decline is energy is somewhat puzzling given that energy earnings comparisons are the most favorable they have been in about two years.

Although 2017 leadership to date remains with economically sensitive sectors, we learned last year how quickly sector leadership can change. In this environment in which there is wide dispersion of returns and frequent leadership changes, we recommend trading within existing positions as opposed to making whole-position trades. This includes selling on strength and buying on weakness among high-quality and trusted names in your portfolio.

We have performed our normal quarterly rebalancing of our sector recommendations. Our rebalancing process uses a variety of inputs, beginning with sector stock momentum on a one-month, three-month, and year-to-date basis. We look at the delta between the market's current P/E and its trailing five-year P/E, measure the same relationship between sector current and historical P/Es, and uses those deltas vs. the market to discover undervaluation. Other inputs include earnings growth, measuring both EPS acceleration and average two-year growth relative to the market; analyst conviction as measured in percentage of Sector BUY ratings; and Chief Investment Strategist's sector recommendations based on his quality and safety screens.

After performing sector analysis via our six-part process, we have adjusted sector allocations. We have made the following change in recommended weightings for the third quarter of 2017. We have raised the Consumer Discretionary sector to Over-Weight from Market-Weight. While retail stocks continue to drag on the sector, growth is accelerating in key areas including hospitality & restaurants, media, housing materials, and automotive parts and services. And we have raised Consumer Staples to Market-Weight from Under-Weight. Sector valuations have become more attractive as wage gains are helping consumers move from generics to name brands.

We have lowered Financial Services to Market-Weight from Over-Weight. With the rise in rates materializing more slowly than anticipated, bank fundamentals have not caught up with the surge in sector stocks that occurred post-election. We also lowered Telecom Services to Under-Weight from Market-Weight, as broadband data price wars continue to weigh on ARPU and on sector operating fundamentals in general. And finally, we have lower REITs from Market-Weight to Under-Weight, as the rolling tide of store closing ripples across the sector.

Global stocks followed U.S. stocks upward in May. Compared to one month ago, our aggregate of international stock markets showed about 120 basis points of appreciation. And the aggregate is up about in line with blue-chip U.S. stocks in the year to date.

The most notable trend change is in our basket of resource-sensitive stock markets. As commodity prices including oil have softened, our commodity basket has slipped to down 2% year-to-date on average from up 2% year-to-date on average one month ago. BRIC performance has improved, even though Russia's stock market woes have intensified. That weakness has been offset by strength in China, up 24% to lead the global markets year-to-date.

Our Americas composite is up 6%, lagging the international average primarily on Canadian weakness. Mature economy markets are up 10%. Stock-price momentum appears to be shifting to growth economies, including several too immature to be featured in our composite.

CONCLUSION

We think the pause in new vehicle spending could last for a while. Housing is subject to mild ebbs and flows that are sometimes exaggerated in the seasonally adjusted data. Retail sales remain solid if not spectacular, as consumers navigate the enormous secular disruption eCommerce is wreaking on brick & mortar retail. While we are not counting out the consumer, we no longer look for them to lead economic recovery and growth.

We believe the baton has been passed to the industrial & commercial economy. We look for improving industrial economic activity to partly offset any consumer slack. In coming months, we will be focused on commodity prices, durable goods orders, industrial production and capacity utilization for signs they can extend their recent strength and in the process help sustain economic recovery.

The earnings season, which was a nice stock-market driver, is past; and stocks are going to have to succeed on their own merits. While we would be mindful of "Sell in May" as May gives way to June, axioms do replace an investment strategy. We would remain long this market, which appears to have a few more legs to go.

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